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DEPARTMENT FOR EUR/ERA, TREASURY FOR OASIA

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TAGS: ECON EFIN HR PGOV
SUBJECT: WIDE DIVERGENCE OF VIEWS ON PROSPECT OF DEBT
FINANCING CRISIS IN 2009

¶1. (SBU) SUMMARY: Since the government has failed in its goal to balance the 2009 budget (septel), instead turning in a plan for a 0.88 percent of GDP deficit, experts inside and outside the government are discussing with renewed vigor whether or not the economy can maintain the necessary liquidity to avoid a major collapse next year. Individuals in the financial services industry, as well as the head of Croatia's largest tour operator, have told us it is just a matter of time before the government is forced to turn to the IMF for aid. Within the government, officials of the central bank have not surprisingly been more optimistic, saying that financing has already been lined up through at least the first quarter of 2009. Nevertheless, the central bank today downgraded yet again its GDP growth forecast to 1 percent for 2009, suggesting that pressure on the state budget could be even higher. Croatia continues to have real advantages in significant foreign reserves and a stable banking system, but the mood in the private sector continues to darken, and the government is finding it increasingly difficult to put a positive spin on the situation. END SUMMARY.

¶2. (SBU) Conversations with private sector business leaders reveal a generally sour mood. A prominent American businessman in the financial services industry, who has long experience in Croatia, told the Ambassador this week that a Croatian government debt default was a real possibility and that IMF aid was simply a matter of time. The chief economist at the Croatian subsidiary of Raiffeisen Bank, as well as the head of the Croatian Employers Association, have recommended in the press that the government bring in the IMF sooner rather than later. The CEO of Croatia's largest tour operator, accounting for a third of bookings in Croatia's most important foreign exchange earner, told us to expect a serious economic slowdown next year as tourist numbers drop and private sector companies struggle to find new lines of credit. Indeed, according to Raiffeisen Bank, private companies' foreign debt increased 40 percent last year, accounting for by far the largest share of Croatia's overall stock of foreign debt (an estimated 95 percent of GDP).

¶3. (U) Officials at the Croatian central bank (HNB) understandably present a more optimistic face, and seem to have the plans in place to back up their claims that the crisis is manageable, for now. According to the HNB's Director of Financial Stability, Croatia has already lined up the funds necessary to finance government debt through the first quarter of 2009. He also claimed that second quarter debt financing should be manageable on the domestic market. The plan for the second half of 2009 is, market permitting, to issue a euro-bond in the neighborhood of 1 billion euro. The HNB also points to its substantial foreign currency reserves, an estimated 8 billion euro. The HNB governor yesterday said he would be the first to recommend turning to the IMF if he felt the situation were to become unsustainable. He then announced that the HNB was

downgrading GDP growth forecasts for next year from 2 percent to 1 percent.

¶4. (SBU) COMMENT: The government's inability to balance the budget adds another degree of risk to an already fragile outlook for 2009. And given the fact that government revenue forecasts are based on a presumption of 2 percent GDP growth, the deficit could easily spike even higher next year. Croatia's high level of foreign reserves and reasonably stable banking system continue to be bright spots for the economy. There also continues to be a high level of suppport for and confidence in the HNB. However, uncertainty in the economy's fortunes has reached the point where there is little room for error next year, or for any additional unforeseen negative shocks. END COMMENT.
WALKER